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Gross Income Under IRC § 61 and Related Sections

SUMMARY

When preparing tax returns, taxpayers must complete the crucial calculation of gross income for the taxable year to determine the tax they must pay. Gross income has been among the Most Litigated Issues in each of the National Taxpayer Advocate's Annual Reports to Congress.¹ For this report, we reviewed 79 cases decided between June 1, 2017, and May 31, 2018. The majority of cases involved taxpayers failing to report items of income, including some specifically mentioned in Internal Revenue Code (IRC) § 61 such as wages,² interest,³ dividends,⁴ and pensions.⁵

TAXPAYER RIGHTS IMPACTED⁶

- *The Right to Be Informed*
- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to Appeal an IRS Decision in an Independent Forum*
- *The Right to a Fair and Just Tax System*

PRESENT LAW

IRC § 61 broadly defines gross income as “all income from whatever source derived.”⁷ The U.S. Supreme Court has defined gross income as any accession to wealth.⁸ The concept of “gross income” is to be broadly construed, while exclusions from income are to be narrowly construed.⁹ However, over time, Congress has carved out numerous exceptions and exclusions from this broad definition of gross income, and has based other elements of tax law on the definition.¹⁰

The Commissioner may identify particular items of unreported income or reconstruct a taxpayer's gross income using methods such as the bank deposits method.¹¹ If the Commissioner determines a tax

1 See, e.g., National Taxpayer Advocate 2017 Annual Report to Congress 420-427; National Taxpayer Advocate 2013 Annual Report to Congress 355-361.

2 Internal Revenue Code (IRC) § 61(a)(1). See, e.g., *Fleming v. Comm'r*, T.C. Memo. 2017-120.

3 IRC § 61(a)(4). See, e.g., *Avrahami v. Comm'r*, 149 T.C. No. 7 (2017).

4 IRC § 61(a)(7). See, e.g., *Povolny Group, Inc.*, T.C. Memo. 2018-37.

5 IRC § 61(a)(9). See, e.g., *Azam v. Comm'r*, T.C. Memo. 2018-72.

6 See Taxpayer Bill of Rights (TBOR), www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR are also codified in the IRC. See IRC § 7803(a)(3).

7 IRC § 61(a).

8 *Comm'r v. Glenshaw Glass*, 348 U.S. 426, 431 (1955) (interpreting § 22 of the Internal Revenue Code of 1939, the predecessor to IRC § 61).

9 See *Comm'r v. Schleier*, 515 U.S. 323, 327-328 (citations omitted) (1995); *Taggi v. U.S.*, 35 F.3d 93, 95 (citations omitted) (2d Cir. 1994).

10 See, e.g., IRC §§ 104 (compensation for injuries or sickness); 105 (amounts received under accident and health plans); 108 (income from discharge of indebtedness); 6501 (limits on assessment and collection, determination of “substantial omission” from gross income).

11 IRC § 6001. See, e.g., *DiLeo v. Comm'r*, 96 T.C. 858, 867 (1991).

deficiency, the IRS issues a Statutory Notice of Deficiency.¹² If the taxpayer challenges the deficiency, the Commissioner's notice is entitled to a presumption of correctness; the taxpayer bears the burden of proving that the determination is erroneous or inaccurate.¹³

ANALYSIS OF LITIGATED CASES

In the 79 opinions involving gross income issued by the federal courts and reviewed for this report, gross income issues most often fell into two categories: (1) what is included in gross income under IRC § 61, and (2) what can be excluded under other statutory provisions. A detailed list of the cases appears in Table 4 of Appendix 3.

In 37 cases (about 47 percent), taxpayers were represented, while the rest were *pro se* (without counsel). Nine of the 37 cases where taxpayers had representation (about 24 percent) prevailed in full or in part in their cases, whereas *pro se* taxpayers prevailed in full or in part in seven cases (about 17 percent). Overall, taxpayers prevailed in full or in part in 16 of 79 cases (about 20 percent).

Drawing on the full list in Table 4 of Appendix 3, we have chosen to discuss cases involving damage awards, income treatment under U.S. tax treaties, and a case of first impression involving the treatment of an excess state tax credit.

Damage Awards

Taxation of damage awards continues to generate litigation. This year, taxpayers in at least seven cases (about eight percent of those reviewed) challenged the inclusion of damage awards in their gross income, but no taxpayers prevailed in these cases.¹⁴

IRC § 104(a)(2) specifies that damage awards and settlement proceeds¹⁵ are taxable as gross income unless the award was received “on account of personal physical injuries or physical sickness.”¹⁶ Congress added the “physical injuries or physical sickness” requirement in 1996;¹⁷ until then, the word “physical” did not appear in the statute. The legislative history of the 1996 amendments to IRC § 104(a)(2) provides that “[i]f an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as payments received on account of physical injury or physical sickness...[but] emotional distress is not considered a physical injury or physical sickness.”¹⁸ Thus, damage awards for emotional distress are not considered as received on account of physical injury or physical sickness, even if the emotional distress results in “insomnia, headaches, [or] stomach disorders.”¹⁹

12 IRC § 6212. See also Internal Revenue Manual (IRM) 4.8.9.2, *Notice of Deficiency Definition* (Aug. 11, 2016).

13 See IRC § 7491(a) (burden shifts only where the taxpayer produces credible evidence contradicting the Commissioner's determination and satisfies other requirements). See also *Welch v. Helvering*, 290 U.S. 111, 115 (1933) (citations omitted).

14 See, e.g., *Bell v. U.S.*, 290 F. Supp. 3d 166 (D. Conn. 2017).

15 See Treas. Reg. § 1.104-1(c) (damages, for purposes of IRC § 104(a)(2), means amounts received (other than workers' compensation) “through prosecution of a legal suit or action, or through a settlement agreement entered into in lieu of prosecution”).

16 IRC § 104(a)(2).

17 Pub. L. No. 104-188, § 1605(a), 110 Stat. 1755, 1838 (1996).

18 H.R. REP. NO. 104-586, at 143-44 (1996) (Conf. Rep.).

19 H.R. REP. NO. 104-737, at 301 (1996) (Conf. Rep.). Note, however, that IRC § 104(a)(2) excludes from income damages, up to the cost of medical treatment for which a deduction under IRC § 213 was allowed for any prior taxable year, for mental or emotional distress causing physical injury.

To justify exclusion from income under IRC § 104, the taxpayer must show settlement proceeds are in lieu of damages for physical injury or sickness.²⁰ In *Bell v. U.S.*, the taxpayers (husband and wife) sought a refund of taxes withheld from a settlement payment received by Dr. Bell.²¹ The taxpayers attempted to assert that the settlement was payment for a physical injury and thus should be exempt from taxation. The court first looked to the payor's intention to determine the nature of the settlement payment. In this case, the supplemental agreement signed by Dr. Bell and his employer specified release with regard to any claim arising from his employment and termination of employment, not tort-type rights. Second, the court considered whether the damages sought were for physical injuries or physical sickness under IRC § 104(a)(2).²² While Dr. Bell argued that he intended to bring claims related to the intentional infliction of emotional distress and the negligent infliction of emotional distress, which are both torts under Connecticut state law, and thus the release also covered these, giving rise to tort-type claims, the court disagreed. Further, the court found that even if Dr. Bell had released these tort-type claims, damages for emotional distress are not physical injuries or sickness under IRC § 104(a)(2). Thus, the court held that the payment from the settlement contract is considered wages, and therefore the taxpayers were not entitled to a refund of taxes withheld from the settlement proceeds.²³

As illustrated by continuing litigation of the characterization of settlement damages, the question of when damage awards can be excluded from gross income continues to confuse taxpayers. The National Taxpayer Advocate notes that taxpayers continue to disagree with the IRS's and courts' interpretation that mental illness equates to emotional distress, as opposed to physical sickness or injury.²⁴ In the same way that a physical injury or sickness may have mental or emotional side effects, many mental illnesses manifest themselves as physical symptoms. For instance, many people who have severe depression experience the following physical symptoms: stomachaches, indigestion, constant headaches, tightness in the chest, difficulty breathing, and fatigue.²⁵ Physical symptoms occur in other mental disorders, such as Post-Traumatic Stress Disorder (PTSD), which affects people who have experienced a traumatic event, such as mugging, rape, torture, being kidnapped or held captive, child abuse, car accidents, train wrecks, plane crashes, bombings, natural or human-caused disasters, or military combat.²⁶ Current research shows the experience of trauma can cause neurochemical changes in the brain that create a vulnerability to hypertension and atherosclerotic heart disease, abnormalities in thyroid and other hormone functions, and increased susceptibility to infections and immunologic disorders that are associated with PTSD.²⁷ The interpretation that mental illness equates to emotional distress seems particularly outdated when

20 See, e.g., *Green v. Comm'r*, 507 F.3d 857 (5th Cir. 2007), *aff'g* T.C. Memo. 2005-250.

21 290 F. Supp. 3d 166 (D. Conn. 2017).

22 See also *Abrahamsen v. U.S.*, 228 F.3d 1360, 1363 (Fed. Cir. 2000).

23 "Whether a specific settlement agreement falls into one of the exceptions for taxable wages under [the Federal Insurance Contributions Act] calls for the same standard as whether a settlement agreement is excluded from gross income." *Bell*, 290 F. Supp. 3d at 170 (citation omitted).

24 See, e.g., *Collins v. Comm'r*, T.C. Summ. Op. 2017-74; *Devine v. Comm'r*, T.C. Memo. 2017-111.

25 National Institute of Mental Health, *Signs and Symptoms of Depression*, <https://www.nimh.nih.gov/health/topics/depression/index.shtml> (last visited Aug. 30, 2018).

26 National Institute of Mental Health, *Post-Traumatic Stress Disorder*, <http://www.nimh.nih.gov/health/topics/post-traumatic-stress-disorder-ptsd/index.shtml> (last visited Aug. 30, 2018).

27 See U.S. Department of Veterans Affairs, *National Center for PTSD*, <http://www.ptsd.va.gov/professional/co-occurring/ptsd-physical-health.asp> (last visited Aug. 30, 2018).

considering the medical advancements in understanding the physical cause and symptoms of mental illness.²⁸

Income Under Tax Treaties

Taxpayers in at least six cases argued that various items of income were excludable under a variety of tax accords, conventions or treaties.²⁹ Only one taxpayer prevailed in part in this series of cases.³⁰ Each case required the courts to interpret the terms of the treaty, convention or accord in relation to the item of income the taxpayer was attempting to exclude.

In *Guo v. Commissioner*, the Tax Court considered, in a matter of first impression, the taxpayer's contention that his unemployment compensation is exempt from income tax under the Convention with Respect to Taxes on Income and Capital between Canada and the United States.³¹ In this case, the taxpayer was a Canadian citizen who worked in the U.S. as a post-doctoral fellow. When her employment concluded, she returned to Canada and applied to the state of Ohio for unemployment compensation.

The taxpayer received unemployment compensation from Ohio during 2012 and Ohio issued her a 1099-G, *Certain Government Payments*, reflecting no federal income tax withheld. She timely filed her 1040NR-EZ, *U.S. Income Tax Return for certain Nonresident Aliens with No Dependents*, and took the position that her unemployment compensation was excludable under the treaty. The Commissioner and the taxpayer agreed that she received the unemployment compensation, that it was an item of gross income, and it was "effectively connected" to the conduct of the taxpayer in relation to a U.S. trade or business.³² However, the Commissioner and the taxpayer disagreed over the exclusion of the income under the treaty.

The court looked first to the written language of the treaty and noted that neither the treaty nor its protocols specify how unemployment compensation should be treated. The taxpayer argued that under article XV of the treaty, unemployment compensation falls into the category of "salaries, wages, and other similar remuneration."³³ The court found that unemployment compensation is neither salary nor wages, and remuneration is not defined in the treaty. It next turned to the IRC for a definition of remuneration, where it is also not defined; however, the court found the location of the term within the IRC and its context to provide guidance and found it closely associated with wages paid for services.³⁴ Thus, the court found that unemployment compensation is not remuneration as it is not wages or

28 National Taxpayer Advocate 2009 Annual Report to Congress 351-56 (Legislative Recommendation: *Exclude Settlement Payments for Mental Anguish, Emotional Distress, and Pain and Suffering from Gross Income*). The National Taxpayer Advocate recommended that Congress amend IRC §104(a)(2) to exclude from gross income payments received as settlement for mental anguish, emotional distress, and pain and suffering. Such change was recommended because mental anguish, emotional distress, and pain and suffering can be caused by a physical condition in the body and can cause physical symptoms. Over the past few years, doctors and researchers have made significant advances in identifying changes that occur in the brain when a person is plagued with mental illness.

29 See, e.g., *Ye v. Comm'r*, T.C. Memo. 2017-216.

30 See *Kiselev v. Comm'r*, T.C. Summ. Op. 2018-2.

31 *Guo v. Comm'r*, 149 T.C. No. 14 (2017), *appeal dismissed*, 2018 WL 3216499 (D.C. Cir., May 11, 2018).

32 *Id.*

33 *Id.*

34 Two places in the IRC that mention remuneration are IRC § 3401 (definitions for withholding income tax from wages) and IRC § 3121 (definitions for withholding federal insurance contributions act taxes from wages).

benefits paid by an employer to an employee but “other income” under article XXII of the treaty,³⁵ which is not excludable from U.S. taxation.

Refundable State Tax Credits

The Court of Federal Claims decided a case of first impression regarding the characterization and taxability of targeted New York State tax credits.³⁶ New York State offers state income tax credits to businesses or individuals who meet the requirements of the tax credit program. The purpose of the program is to rehabilitate targeted areas of New York. The program applies a percentage of the cost of the project against a corporation’s franchise tax or an individual’s income tax liability and any amount in excess of that owed can be deferred to another tax year or credited as an overpayment. New York does not tax any part of the credit. In *Ginsburg v. Commissioner*, the taxpayers (a husband and wife) received an excess credit of nearly \$2 million from New York State, which they did not include as income on their tax return.³⁷ The IRS conducted an audit and asserted a tax deficiency. Mr. and Mrs. Ginsburg then paid the deficiency and brought a refund suit. They argued that the excess credit was not income, as it was a classic recovery of capital. Alternatively, they argued the excess credit is excludable from gross income as a nontaxable contribution to capital. The Commissioner asserted the excess credit is a cash subsidy and not excludable from gross income.³⁸ Both parties moved for summary judgment.

Similar to the case of *Maines v. Commissioner*, which we discussed in a previous report, the court in *Ginsburg* found that while New York treated the credit as a nontaxable refund, federal law ultimately controls how state-created interests are taxed under the federal income tax.³⁹

The court found that the excess credit was nothing more than a cash transfer to the taxpayers, and on its face was income, unless an exclusion from income could be applied. The court next considered the theories of capital recovery and nontaxable contribution to capital advanced by the taxpayers. The court determined that the recovery of capital doctrine is limited to the sale of goods, which is not applicable in the instant matter.⁴⁰ The court also rejected the taxpayers’ contention that the excess credit was a contribution to capital by New York State and thus not taxable. The court noted that the transfer was not made for an interest in the taxpayers’ partnership and the taxpayers freely chose to participate in the program. As a result, the excess credit was income to the taxpayers and did not qualify for any exception or exclusion from gross income.⁴¹

35 Article XXII of the treaty was captioned “Other Income” and served as a catchall provision to cover items of income not dealt with elsewhere in the treaty. It expressly provided that the U.S. could tax items of income arising in the U.S.

36 *Ginsburg v. U.S.*, 136 Fed. Cl. 1 (2018), *appeal docketed*, No. 18-1788 (Fed. Cir., Mar. 30, 2018).

37 136 Fed. Cl. 1 (2018), *appeal docketed*, No. 18-1788 (Fed. Cir., Mar. 30, 2018).

38 *Ginsburg v. Comm’r*, 136 Fed. Cl. 1 (2018), *appeal docketed*, No. 18-1788 (Fed. Cir., Mar. 30, 2018).

39 *Maines v. Comm’r*, 144 T.C. 123 (2015). See National Taxpayer Advocate 2015 Annual Report to Congress 479-80.

40 As the District Court for the Eastern District of New York explained in the case of *In re Tax Refund Litigation*, 766 F. Supp. 1248 (E.D.N.Y. 1991), “There can be no return of capital until, as in the case of a manufacturer or merchandiser, that asset is sold or exchanged by the lessor.” In *Ginsburg v. Commissioner*, the taxpayer retained all ownership of the property in question, therefore, there could be no return of capital since the taxpayer had not divested of the asset for which he claimed to be recovering capital.

41 *Ginsburg v. Commissioner*, 136 Fed. Cl. 1 (2018), *appeal docketed*, No. 18-1788 (Fed. Cir., Mar. 30, 2018).

CONCLUSION

Taxpayers litigate many of the same gross income issues every year due to the complex nature of what constitutes gross income. As the definition is very broad and the courts broadly interpret accession to wealth as gross income, most cases were decided in favor of the IRS and exclusions from gross income continued to be narrowly interpreted.

Overall, litigation of items of gross income decreased this year, from 85 cases in the 2017 reporting cycle to 79 cases this year.⁴² The number of cases involving the tax treatment of settlements and awards held steady in this reporting cycle at seven; thus, it clearly remains a perennial area of confusion for taxpayers. The National Taxpayer Advocate has previously recommended a legislative change that would clarify the tax treatment of court awards and settlements by permitting taxpayers to exclude any payments received as a settlement or judgment for mental anguish, emotional distress, or pain and suffering.⁴³

One new area appeared in the issues reviewed this year and presented the Tax Court with an issue of first impression involving the treatment of income under various tax treaties. Previous reporting cycles did not identify cases in this area.⁴⁴ Taxpayers litigated this issue with only minor success this year, prevailing in part in only one case.

42 National Taxpayer Advocate 2017 Annual Report to Congress 420-427.

43 National Taxpayer Advocate Annual 2009 Report to Congress 351-356 (Legislative Recommendation: *Exclude Settlement Payments for Mental Anguish, Emotional Distress, and Pain and Suffering from Gross Income*).

44 See, e.g., National Taxpayer Advocate 2017 Annual Report to Congress 544-546 (Appendix 3).